



U.S. Department of Agriculture



Office of Inspector General
Midwest Region

Audit Report

Controls over Single Family Housing Funds Provided for Hurricane Relief Efforts

Report No. 04601-0015-Ch
March 2007



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



MAR 30 2007

REPLY TO

ATTN OF: 04601-0015-CH

TO: Russell T. Davis
Administrator
Rural Housing Service

THROUGH: John Dunsmuir
Acting Director
Financial Management Division

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Controls Over Single Family Housing Funds Provided for Hurricane Relief Efforts

This report presents the results of our audit of hurricane relief efforts by the Rural Housing Service. Our audit evaluated the agency's systems and processes for ensuring the accountability of single family housing assistance earmarked for disaster relief.

The agency response to the official draft report is included in exhibit C, with excerpts and the Office of Inspector General's position incorporated into the Findings and Recommendations section of the report. Based on the response, we have reached management decisions on Recommendations 1 and 9. Please follow your agency's internal procedures in forwarding documentation for final action to the Office of the Chief Financial Officer.

Management decisions have not been reached on Recommendations 2, 3, 4, 5, 6, 7, 8, and 10. The Findings and Recommendations section of this report includes a description of the information needed to reach management decisions for these recommendations.

In accordance with Departmental Regulation 1720-1, please provide a reply within 60 days which includes the timeframe for completing the corrective actions. Please note that the regulation requires management decisions to be reached on all recommendations within a maximum of 6 months from report issuance, and final action be taken within 1 year of each management decision.

We appreciate the courtesies and cooperation extended to us by your staff.

Executive Summary

Results in Brief

The cumulative impact of Hurricanes Katrina and Rita is considered by many to be the worst natural disaster in U.S. history. The aftermath of those storms left thousands of individuals and families homeless. Shortly after the storms, Congress provided emergency housing funding to Federal agencies, including Rural Development, in an effort to assist victims directly impacted by the hurricanes. For Rural Development, this included almost \$1.3 billion for guaranteed housing loans, \$176 million for new direct loans, \$34 million for direct repair loans, and \$20 million for repair grants.

We focused our review on the issuance of the \$54 million in direct repair loans and grants because the agency was primarily distributing these funds at the time of our review. Conversely, at the time of our audit, agency officials had not disbursed much of the almost \$1.5 billion in guaranteed and direct new loan funds authorized by the Emergency Supplemental Appropriations Act (the “act”). Thus, we did not examine the propriety of guaranteed and direct new loans, including the eligibility of loan recipients.

Rural Development field officials in Mississippi and Louisiana, the two States most impacted by the hurricanes, received over 13,000 loan and grant applications (as of October 2006). This was a formidable task for field staff who were accustomed to handling significantly fewer applications. For instance, the three field offices we visited in Mississippi normally processed about 25 applications each per year. However, by February 2006, six months after Hurricane Katrina, those offices had received an average of 1,677 applications. Thus, considering the circumstances, it is not surprising that we found procedural errors and internal control weaknesses.

In the absence of any formal written emergency procedures to address a disaster of this magnitude, Rural Housing Service (RHS) officials provided guidance following the hurricanes in the form of eight unnumbered letters, three of which were issued in September 2005. While this guidance generally answered immediate pressing questions for field staff, it did not address some major internal control issues. Thus, in light of the problems that occurred after the Gulf Coast disaster, and the likelihood that other disasters will occur in the future, agency officials should develop and implement controls before the next disaster to ensure that housing funds are properly spent.

A key area that had not been addressed by Rural Development and RHS, as well as other Federal agencies, was coordination in the delivery of housing assistance to hurricane victims. We found that other Federal agencies such as the Federal Emergency Management Agency, the U.S. Department of Housing and Urban Development, and the Small Business Administration,

had also provided emergency housing assistance to hurricane victims. While we were unable to find any specific duplication of assistance (because there were no existing computer matching agreements), we consider it likely that some individuals received unnecessary assistance in the form of loans and grants from Rural Development.

The absence of policies also could have allowed individuals residing in the disaster area to receive overlapping housing assistance and reimbursements from Rural Development, charitable organizations, and homeowners' insurance companies. Early in our review, we identified six applications (of 95 reviewed) where applicants received funds or assistance from insurance companies and charitable organizations for the same repairs included on their Rural Development applications. Those applicants were eligible to receive up to \$90,000 in emergency grant funds.

We immediately alerted RHS officials about this issue. Those officials issued a memorandum to field staff in the disaster area instructing them to make reasonable efforts to verify that applicants had not already received assistance from other sources. The memorandum also stated that, depending on the circumstances, field staff should verify insurance coverage with the first mortgage lender and insurance company.

RHS officials also considered the act to be economic recovery legislation and, thus, adopted a policy that provided emergency funds for non-hurricane related repairs and improvements. We found that almost 94 percent of the grant applications we reviewed (59 of 63) included over \$320,000 in repairs and improvements that were not related to hurricane damage. Since there were 151 unfunded applications in Mississippi as of October 2006, which is after the agency had exhausted most of its emergency funds for repair grants, it is likely that this policy excluded some applicants who actually had hurricane-related damage.

We also found instances in Mississippi where: (1) grant funds were used for prohibited types of repairs and improvements; (2) staff had not detected that unlicensed contractors were making repairs involving grant funds; and (3) there was no separation of duties between the loan and grant origination process, and the approval process. In our review, about 59 percent (37 of 63) of the grant applications included almost \$69,000 in repairs and improvements not related to health, safety, or handicap accessibility, as required by program regulations. In addition, about 30 percent (13 of 44) of the approved grant applications that exceeded \$10,000 involved the use of unlicensed contractors, which violated agency regulations and State law. The 13 applications totaled almost \$209,000. Finally, disaster funds were vulnerable to misuse because field officials were not following guidelines related to the duties of their positions.

We found that all loan and grant applications we examined at two field offices were received, reviewed, and approved by the same employee.

Rural Development officials had not identified borrower accounts (direct loans) in the disaster area that were in jeopardy of default, or the number and cost associated with uninhabitable properties that would likely need to be destroyed. (They had estimated losses for the Guaranteed Loan Program.) We estimated that 59 percent of the properties we visited (79 of 135) in Louisiana were in jeopardy of default, and 91 percent (123 of 135) of those properties were uninhabitable and would need to be demolished or require major rehabilitation.

This review was conducted in conjunction with the President's Council on Integrity and Efficiency (PCIE) as part of its examination of relief efforts provided by the Federal government in the aftermath of Hurricanes Katrina and Rita. As such, a copy of the report has been forwarded to the PCIE Homeland Security Roundtable, which is coordinating Inspectors General reviews of this important subject.

Recommendations in Brief

We recommend that RHS officials prepare for future disasters by developing policy and procedures for coordinating actions related to single family housing with other Federal agencies. While Rural Development and RHS' role is not in the emergency housing area, it is likely that it and other Federal agencies will be asked to provide support in future disasters, both natural and man-made. Thus, while Rural Development may not be in a lead role, it can perform an important supporting role in providing housing loan and grant funds to disaster victims. We also recommend that agency officials develop and implement policies and procedures before the next disaster to ensure that housing funds are properly spent, and in accordance with established legislation.

Agency Response

In their response dated, March 23, 2007, agency officials generally agreed with the findings and recommendations contained in the report. However, they did not agree with Finding 3 regarding the use of emergency funds for repairs unrelated to hurricane damage. Actions on some of the recommendations are underway while others will be. We have incorporated applicable portions of the response, along with our position, in the Findings and Recommendations section of this report. The agency's response is included in its entirety as exhibit C of the report.

OIG Position

We agree with the actions the agency has underway in response to our recommendations. The disaster, as mentioned in the response, was unprecedented. We have reached management decision on Recommendations 1 and 9. We can reach management decision on Recommendations 2, 3, 6, 7, 8 and 10 once the agency informs us of all proposed corrective actions and the timeframes when those actions will be completed. For Recommendations 4 and 5, agency officials need to obtain an OGC opinion regarding the appropriate use of emergency funds prior to approving applications for future disasters, and develop procedures that provide guidance to field staff on the proper use of such funds.

Abbreviations Used in This Report

CSC	Centralized Servicing Center
DHS	United States Department of Homeland Security
FEMA	Federal Emergency Management Agency
HUD	United States Department of Housing and Urban Development
OGC	Office of the General Counsel
OIG	Office of Inspector General
PCIE	President's Council on Integrity and Efficiency
RHS	Rural Housing Service
SBA	Small Business Administration
SFH	Single Family Housing
USDA	United States Department of Agriculture

Table of Contents

Executive Summary	i
Abbreviations Used in This Report	v
Background and Objectives	1
Findings and Recommendations.....	4
Section 1 Policies to Prevent and Detect Unnecessary Payments	4
Finding 1 Coordination with other Federal Agencies Before and After Providing Assistance.....	5
Recommendation 1	6
Finding 2 Insurance and Charitable Assistance Not Disclosed	7
Recommendation 2	10
Recommendation 3	10
Finding 3 Funds Provided for Non-Hurricane Related Repairs	11
Recommendation 4	13
Recommendation 5	14
Section 2 Controls Over Disbursement of Funds	15
Finding 4 Ineligible Repairs and Improvements	15
Recommendation 6	17
Finding 5 Repairs Performed By Non-Licensed Contractors.....	18
Recommendation 7	21
Recommendation 8	21
Finding 6 Separation of Duties Lacking for Loan and Grant Processing.....	22
Recommendation 9	25
Section 3 Asset Management.....	25
Finding 7 Potential Losses Unknown for Direct Housing Portfolio.....	25
Recommendation 10	29
Scope and Methodology.....	30
Exhibit A – Summary of Monetary Results	32
Exhibit B – Photographs of Damage to Agency Financed Housing	33
Exhibit C – Agency Response	36

Background and Objectives

Background

The USDA Office of Inspector General (OIG) is participating in a Government-wide endeavor to assess agency relief efforts related to Hurricanes Katrina and Rita that hit the Gulf Coast region on August 29, 2005, and September 24, 2005, respectively. The U.S. Department of Homeland Security's (DHS) OIG is coordinating these activities, involving 19 Departments and their respective OIG's, through the President's Council on Integrity and Efficiency (PCIE) Homeland Security Roundtable. Within the framework of the PCIE, we evaluated Rural Development's effort to assist disaster victims through its Single Family Housing (SFH) Loan and Grant Programs.

Rural Development provides homeownership to low and moderate-income rural individuals through direct and guaranteed loans. In addition, it provides repair loans and grants to make homes decent, safe, and sanitary. Rural Development administers the SFH Program through the Rural Housing Service (RHS) located in Washington, D.C., as well as 47 State offices, and 800 area and local offices.

The agency provides direct financial assistance to individuals and families in the form of home loans. The loans are used for the purchase of an existing home or for new home construction. Most direct loans are made to families with income below 80 percent of the median income level in the communities where they live and who would otherwise not qualify for a conventional loan. The interest on these loans is subsidized to make them more affordable to homeowners. In addition, Rural Development guarantees loans made by private sector lenders to moderate income individuals and families. If a borrower defaults on a guaranteed loan, Rural Development pays the private lender for the outstanding balance on the loan.

Individuals and families with very low income, and whose homes are in need of repair, are eligible for loans and grants for renovation. This aspect of the SFH Program provides funds to individuals and families for repairs related to health and safety issues. For example, funds may be used to repair a leaking roof; to replace a wood stove with central heating; to construct a front-door ramp for someone using a wheelchair; or to replace an outhouse and pump with running water, a bathroom, and a waste disposal system. When repairs to properties are made under this program, agency regulations require that major health and safety hazards that make a home unfit for habitation must be repaired. Generally, homeowners must be 62 years and older to be eligible for grants. However, this requirement was waived in the Gulf Coast region in March 2006 by the Emergency Supplemental Appropriations Act (the "act").

The cumulative impact of the hurricanes left thousands of individuals and families homeless. In response to the disaster, Congress passed the act, which authorized Rural Development to waive certain program requirements to address damage caused by the Gulf Coast hurricanes in Alabama, Louisiana, Mississippi, Florida, and Texas. In addition, the act provided additional funding for Rural Development's housing programs to respond to hurricane damage in designated disaster areas. This additional funding included almost \$1.3 billion for guaranteed loans, almost \$176 million for direct loans, over \$34 million for direct repair loans, and \$20 million for repair grants. The act allowed Rural Development to use emergency funds to reimburse accounts for expenditures related to damage caused by the Gulf Coast disaster.

Based on the authority provided in the Housing Act of 1949, and on applicable exception provisions in agency regulations, RHS officials issued a series of unnumbered letters providing emergency guidance to State Directors, as follows:

- On September 8, 2005, RHS responded to State office requests for programmatic waivers to assist victims of Hurricane Katrina. The letter authorized waivers for 60 days to individuals and families that were directly impacted by Hurricane Katrina. The waivers included, among others, increasing the rural area designation to areas with a population up to 50,000; relaxing the income and debt requirements for low-income applicants; allowing the use of in-file credit reports in lieu of residential credit reports; allowing field staff to disregard derogatory credit reports after the disaster, and the need to verify employment, wages, and bank deposits; authorizing loan approvals without appraisals; increasing the insurance claim check endorsement limit to \$15,000, and the maximum number of days for completion of work to 180 days; and re-amortizing loans automatically after the moratorium period.
- An unnumbered letter dated September 14, 2005, increased the rural designation from 50,000 to 75,000 for specific communities in Alabama, Louisiana, and Mississippi. This waiver extended for 3 years from the date of the disaster declaration. Another unnumbered letter, dated September 19, 2005, extended the rural population designation to 75,000 for two additional communities in Alabama. Both letters reiterated that the waivers were only available to individuals and families directly impacted by Hurricane Katrina.
- On September 26, 2005, RHS granted all borrowers within the declared disaster areas an automatic six-month moratorium on loan payments. Borrowers did not have to apply for a moratorium. The letter allowed for an extension of the moratorium at the end of the

6-month period. Based upon individual circumstances, RHS had the authority to extend moratoriums to customers in contiguous areas.

- On November 8, 2005, RHS extended the waivers granted for an initial 60 days to one year from the date of the memorandum.
- On December 6, 2005, Rural Development announced the continuation of a foreclosure moratorium on guaranteed loans in the areas impacted by Hurricanes Katrina and Rita. On February 27, 2006, RHS officials granted this moratorium to borrowers impacted by Hurricane Wilma and extended it for another 120 days with restrictions that had to be met by loan holders by March 31, 2006.

The letter stated that on or before March 31, 2006, loan holders and servicing companies had to perform the following actions: (1) assess the status, condition, and habitability of the mortgaged property; (2) establish contact with impacted borrowers and evaluate their short term and long term plans for housing, employment, home repairs and repayment of the mortgage debt; (3) determine borrowers' hazard and flood insurance coverage, property damage and available insurance recoveries; and (4) confirm in writing that borrowers intend to work with the holder or servicing company to develop and implement a plan to repair or rebuild the home and resolve the mortgage delinquency.

- RHS issued another letter on May 25, 2006, in response to issues identified during the OIG audit in the Gulf Coast region. The letter instructed State directors and field staff to make reasonable efforts to verify that applicants for SFH Program loans and grants had not received benefits from other sources such as insurance companies, charitable organizations, and other Government agencies. It also required field staff to obtain a written statement, in the form of a certification statement, from applicants to verify that they have not received any other assistance for the same purpose as the funds being provided by Rural Development.

Objective

To evaluate RHS' systems and processes for ensuring the accountability of single-family housing funds earmarked for disaster assistance.

Findings and Recommendations

Section 1 Policies to Prevent and Detect Unnecessary Payments

Shortly after the Gulf Coast disaster, Congress provided emergency funding to Federal agencies, including Rural Development, to assist hurricane victims. Rural Development was appropriated over \$1.5 billion for housing assistance related to the disaster. We focused our review on the policies and procedures for reviewing and approving applications for this assistance. At the time of our review, the number of direct and guaranteed loans for new construction or purchase of single-family housing was minimal. Thus, much of our activity was related to the \$54 million in repair grant and loan funding.

We found that Rural Development and RHS, as well as other Federal agencies, had not developed policies to coordinate housing assistance provided to victims in the Gulf Coast region. Further, RHS had not developed a policy that required applicants to provide, either during the initial application stage or at a subsequent date, information about damage reimbursement from insurance companies and assistance from charitable organizations.

The absent policies could have allowed individuals residing in the disaster area to receive overlapping housing assistance and reimbursements from Rural Development, other Federal agencies, charitable organizations, and insurance companies. For example, we identified six applications (of 95 reviewed) where applicants received assistance from insurance companies or charitable organizations for the same repairs included on the Rural Development application. Those applicants were eligible to receive up to \$90,000 (\$15,000 each) in emergency grant funds.

RHS also considered the act to be economic recovery legislation and, thus, adopted a policy that provided emergency funds for non-hurricane related repairs and improvements. We found that almost 94 percent of the applications we reviewed (59 of 63) included about \$300,000 in repairs and improvements not related to hurricane damage. Since there were 151 unfunded applications in Mississippi as of October 2006, which is after the agency had exhausted most of its emergency funds for repair grants, it is likely that this policy excluded some applicants who actually had hurricane-related damage.

To the agency's credit, it was a formidable task for field staff to process applications in a timely and accurate manner. At the time of our review, field officials in Mississippi and Louisiana, the two States most impacted by the hurricanes, had received over 13,000 repair loan and grant applications (as of October 2006). This was in sharp contrast to the number of applications normally processed by field offices in those States. For instance, the three

field offices we visited in Mississippi normally processed about 25 applications each per year. However, at the time of our review (May 2006), those offices had received an average of 1,677 applications each since the disaster. Thus, considering the circumstances, it is not surprising that we found procedural errors and internal control weaknesses.

Finding 1**Coordination with other Federal Agencies Before and After Providing Assistance**

One lesson learned as a result of the Gulf Coast hurricanes was that Federal agencies were not prepared to coordinate their efforts to ensure that duplicate assistance was not provided to disaster victims. RHS, as well as other Federal agencies that provide housing assistance, did not have computer matching agreements that would have facilitated coordination. As a result, some individuals likely received unnecessary assistance in the form of loans and grants from Rural Development. In total, Congress appropriated almost \$1.3 billion for guaranteed loans, \$176 million for new direct loans, and \$54 million for repair loans and grants to Rural Development.

For this disaster, we found that other Federal agencies such as the Federal Emergency Management Agency (FEMA), the U. S. Department of Housing and Urban Development (HUD), and the Small Business Administration (SBA), had also provided emergency housing assistance to hurricane victims. During our audit, we worked with other Inspector General offices, and within the framework of the PCIE's Housing Work Group, and attempted to perform computer matches to identify individuals who received duplicate assistance for housing loans and grants. Unfortunately, since there were no existing computer matching agreements with other Federal agencies to facilitate sharing and matching data, we were unable to perform this action, or create the agreements in time to assist us for the Gulf Coast disaster.

Despite the fact that we were unable to conduct a computerized match of recipient data with other Federal agencies after the Gulf Coast disaster, information sharing is, in our view, still the most efficient method to prevent or detect duplicate assistance. The alternative would be to question victims before providing assistance to prevent its occurrence, and after providing assistance, as we did, to expose duplicate payments. However, while questioning applicants allowed us to determine that unnecessary assistance had been provided to victims, it was a time-consuming and arduous process that would be too costly for RHS to implement. Coordination with other Federal agencies would require a formal computer matching agreement between RHS and other agencies providing housing assistance. As

a result of work in the Rural Rental Housing Program (Audit No. 04600-13-Ch), RHS has already initiated action, through the Office of the General Counsel (OGC), to develop such agreements in the multi-family housing area. We have been working with RHS and OGC officials to coordinate their actions with officials from HUD. Our Office of Counsel also recommended to OGC that the initial computer matching agreement with HUD cover the maximum 18-month time period allowed by the Privacy Act and that it apply to all of RHS' housing programs (multi- and single-family). This recommendation would also be applicable to future agreements made with other Federal agencies, such as FEMA and SBA.

Since it is likely that disasters, both natural and man-made, will occur in the future, and that RHS will be asked to provide assistance, the agency would be best served to take a proactive approach while coordinating with other Federal agencies. The best way to do this would be include the SFH Program in the computer matching agreement currently being prepared for the Multi-Family Housing Program. RHS officials acknowledged the benefits of such an agreement during the audit, and were generally agreeable to implementing this recommendation.

Recommendation 1

Include the SFH Program in the computer matching agreement currently being developed with HUD for multi-family housing, and with all subsequent agreements between RHS and other Federal agencies such as FEMA and SBA.

Agency Response

Agency officials stated they have included the SFH Program in a proposed matching agreement between HUD and RHS. They expect the agreement to be executed in the next few months. Also, they will include the SFH Program in subsequent agreements between RHS and other Federal agencies such as FEMA and SBA.

OIG Position

We accept management decision for this recommendation. Final action can be achieved when the agreements are completed and copies are provided to the Office of the Chief Financial Officer.

Finding 2

Insurance and Charitable Assistance Not Disclosed

Individuals residing in the disaster area received assistance from charitable organizations and insurance companies to repair hurricane related damage, and applied for emergency funds for the same repairs provided by Rural Development.¹ We found 6 such instances of duplicate assistance during our review of 95 grant applications, which included visits to the homes of 30 applicants in Mississippi. National and State officials did not require applicants to disclose additional forms of assistance, and had not developed controls to verify that applicants had received such assistance. (RHS officials did issue policy and guidance after we disclosed the problem.) While the 6 applicants had not yet received funds, they were eligible to receive up to \$90,000 (\$15,000 each) in grant funds from Rural Development.

We found that there was no policy requiring field staff to question applicants about such assistance, or procedures to determine if applicants had received reimbursement from insurance companies. Rural Development officials at the State level, and RHS officials at the national office, both stated that they had not developed policy or procedures to address such a situation.

Since many charitable organizations were operating in the disaster area, and insurance companies were reimbursing homeowners for damages, we examined the agency's procedures for ensuring that it was not providing unnecessary assistance to applicants. To accomplish this, we visited three field offices in Mississippi (most repair activity was in that State) and reviewed 95 applications for grants totaling \$872,857 submitted by individuals residing in the disaster areas. At the time, field staff in those offices had approved 109 applications totaling over \$1.3 million.

Agency officials at the field offices we visited were using Form RD 410-4, "Uniform Residential Loan Application," for loan and grant applications to repair damage in the Gulf Coast disaster area. This is the same form that is used under normal operations, and it does not require applicants to disclose funds obtained from other sources, such as insurance companies and charitable organizations, even if the funds are used for the same purpose. (However, the staff at one office had requested this information on its own initiative.)

We were especially concerned that grant funds were being provided to applicants for repairs even though they had received funds from other sources

¹ Section 504 Loan and Grant Program

for the same damage. Consequently, we focused our review on those applications for evidence of mortgage payments, which might indicate that a homeowner had insurance on the property. We also met with 30 applicants at their homes to question them about funds obtained from other sources to pay for damage listed on their grant applications.

During our visits to three homes, we observed that roof damage listed on each application had already been repaired by the homeowner. The homeowners informed us that the repairs had been made by local charitable organizations at little or no cost. One homeowner stated that she had accepted the assistance of the charitable organization because it had taken too long for Rural Development to process the grant.

All three claimed they forgot to notify agency officials, who would have withdrawn the applications. Fortunately, agency officials had not yet obligated funds because they were waiting for contractors to provide repair cost estimates for the roof damages. If, however, contractors had already provided cost estimates for the repairs, agency officials would have obligated funds for the grants, providing an opportunity to disburse unnecessary funds. Considering the volume of activity after any disaster, and that some applicants and contractors may take advantage of such a situation, agency funds could be unwittingly disbursed to ineligible individuals.

Our review also found that three homeowners had included mortgage payments on their applications. In those instances, the homeowners had insurance on their property and had been reimbursed for the same repairs that were listed on their grant applications. In one case, the agency had obligated \$10,735 in grant funds to repair an applicant's roof even though that individual had received \$10,220 from her insurance company to pay for the same damage. In this case, a mortgage company representative informed us that the applicant had homeowners insurance. After we informed agency officials, they contacted the insurance company and learned that it had provided the \$10,220 to repair the applicant's roof. Fortunately, even though the grant had been obligated for payment, funds had not yet been disbursed, and agency officials were able to prevent an unnecessary payout.

We notified the Deputy Administrator for SFH Programs on May 18, 2006, of these issues, and that applicants may be receiving unnecessary loans and grants. On May 25, 2006, the Deputy Administrator issued an unnumbered memorandum to field staff at the State and local levels. The memorandum specified that they needed to make reasonable efforts to verify that the agency was not providing funds to applicants who had already received assistance from other sources. The memorandum also stated that, depending on the circumstances, field staff should verify insurance coverage with the first mortgage lender and insurance company. In

addition, the memorandum stated that an agency official had to ensure that all repairs were made prior to disbursement of loan and grant funds.

Specifically, the memorandum stated, “In processing applications for Direct Section 502 loans and Section 504 Repair loans and grants, it is important to assure that applicants have not received similar benefits from other sources. This includes: Insurance proceeds; benefits from other Government agencies, such as the Federal Emergency Management Agency (FEMA), Small Business Administration (SBA), Housing and Urban Development (HUD), and State or local agencies; charities, such as Red Cross, Mennonite Relief, or Habitat for Humanity; and gifts or aid from any other source.” It also required that all applicants provide a written statement that they had not received any other assistance for the same purpose.

The guidance issued by the Deputy Administrator on May 25, 2006, provides a good foundation for policy to prevent this problem from occurring in future disasters. This guidance should be used to develop formal disaster policy and procedures that require questioning applicants about insurance reimbursements and the receipt of assistance from other sources, such as Government agencies and charitable organizations. In addition, Forms RD 410-4 and 3550-24, or some other mechanism, should require disclosure of other funding sources, and include a certification statement from applicants. The certification statement should state that failure to disclose all required information is a violation of U.S. Code 1001.

Other actions that could uncover undisclosed insurance reimbursements would be to examine mortgage records from county courthouses and credit reports. These actions could identify applicants that potentially had insurance to cover damage related to a disaster. If a mortgage existed, they could determine if insurance was required and, if it was, they could contact the insurance company to identify payments to the applicant.

RHS officials should also develop procedures to monitor field office activities in disaster areas. It had not monitored field office activities during the period of our review. Supervision by State officials from Mississippi had been limited to queries made during weekly conference calls until August 15, 2006, when they began reviews of field offices in the disaster area. However, they consisted of examining only 10 percent of the transactions in each office.²

² The issue of monitoring field activities during a disaster is addressed in detail in Section 2 of this report.

Recommendation 2

Develop policies that require field staff to query individuals about housing assistance received from other sources during disasters, and procedures to identify assistance provided by those sources.

Agency Response

Agency officials will develop formal procedures for future disasters to identify assistance provided by other entities such as insurance companies, relief organizations, and charities. The procedures will also require applicants to certify in writing that they have not received other benefits for the same purpose as the Rural Development assistance. They will use the May 25, 2006, memorandum to field staff, as the basis for the procedures.

OIG Position

We agree with the agency officials' proposed corrective actions. To reach a management decision, they need to provide us with timeframes for completing the corrective actions.

Recommendation 3

Require applicants to disclose any assistance from other sources, and certify that the applicant has provided all information under threat of criminal penalties.

Agency Response

Agency officials will develop formal procedures for future disasters to identify assistance provided by other entities such as insurance companies, relief organizations, and charities. The procedures will also require applicants to certify in writing that they have not received other benefits for the same purpose as the Rural Development assistance. They will use the May 25, 2006, memorandum to field staff, as the basis for the procedures.

OIG Position

We agree with the agency officials' proposed corrective actions. To reach a management decision, they need to provide us with timeframes for completing the corrective actions.

Finding 3

Funds Provided for Non-Hurricane Related Repairs

Rural Development used emergency appropriations, to provide direct loans and grants, for repairs and improvements that were not related to hurricane damage. Almost 94 percent of the applications we reviewed (59 of 63) included repairs and improvements not related to hurricane damage. The act states that emergency funds were provided to respond to damage caused by hurricanes that occurred during the 2005 calendar year. Agency officials considered the act to be economic recovery legislation. Thus, they used the funds to assist any resident in the disaster area who met program requirements. The 59 applications in our review included over \$329,000 in repairs and improvements that were not related to hurricane damage.

On December 30, 2005, Congress passed the act, which appropriated \$210 million for direct loans and \$20 million for grants to assist the Gulf Coast region affected by the disaster. The act stated, in part, that funds were to be used "...to respond to damage caused by hurricanes that occurred during the 2005 calendar year..." In our view, emergency funds were available to assist individuals with damage to their residence caused by the hurricanes.

To determine if emergency funds were being provided for damages caused by the hurricanes, we visited three field offices in Mississippi to review loan and grant applications and observe field office procedures. At two of those offices, we reviewed 63 applications and found 392 repair and improvement items on 59 applications that were not related to damage caused by the hurricanes, which in our view should not have been approved by field officials. Those 392 items totaled \$320,152. In contrast, the 59 applications included 230 items related to hurricane damage that totaled \$433,825.

These items were all related to health, safety, or handicap accessibility, and would have otherwise been allowable if regular program appropriations had been used to fund the projects. However, none were, in our view, major health or safety hazards. For example, 36 of the 59 applications included bathroom improvements such as new commodes and handrails for bathtubs. Another 43 of the 59 applications included new storm windows and doors. Finally, 12 included new kitchen sinks and countertops. None of these improvements were related to hurricane damage or were major health or safety hazards.

Field officials who were approving these items stated they were informed by the national office that all residents in the disaster area were eligible for the

emergency funds. Thus, they were not asking applicants if they had sustained damage from the hurricanes. When we questioned national officials about their interpretation of the act, they stated that it was economic recovery legislation, and that anyone residing in the disaster area, even if they had not incurred hurricane damage, was eligible for the funds.

We requested that RHS provide us with an OGC opinion on the matter. On November 1, 2006, the Deputy Assistant General Counsel provided a written opinion that stated, in part, "... In our opinion, however, the language requires some physical damage directly caused by (some "nexus to") the hurricanes." However, in contrast the opinion stated that "... It is a well established principle that agencies are given deference in the interpretations of statutes and regulations they administer." It also said "... As long as the hurricane-related damage is the impetus for the loan, however, we have no legal concern with other general program purposes being met concurrently." It further added "We agree that attempts to allocate damages between hurricane and non-hurricane causes likely would be administratively burdensome and costly, and, therefore, unreasonable under the circumstances."

We noted that OGC's opinion did not apply to many of the applications we reviewed. For instance, 19 of the applications were submitted prior to the disaster, in some cases up to 2 years before Hurricane Katrina; and 6 applications involved no hurricane-related repairs whatsoever. The remaining applications were submitted after the disaster occurred, and involved a combination of hurricane and non-hurricane repairs; in these cases, it is arguable that Hurricane Katrina did in fact provide the "impetus" for making the repairs as referenced in OGC's opinion.

Congress has, in past instances, made specific provision for Rural Development to use disaster funds for other, "general program purposes" as noted by OGC. In 2004, for instance, Public Law 108-234 provided Rural Development with authority to use loan and grant funds "for projects in communities affected by the hurricanes and tropical storms in calendar year 2003 and 2005," regardless of whether the loans or grants were in response to damage caused by the hurricanes. However, the present Act contains no such language, and instead is plainly worded to limit availability of funds to "damages caused by the hurricanes." Therefore, it is our view that these funds should be available only to applicants who were negatively impacted by the disaster.

The point regarding administrative burden and cost was not applicable for several reasons. First, field officials informed us that they visited the homes of all applicants to determine needed repairs and improvements. The applicants we met with confirmed this, and many added that field officials

spent considerable time with them discussing repairs and improvements to their homes. Therefore, in our view, it would not have been burdensome or costly to determine if damage was related to the hurricanes.

Secondly, as noted above, 6 of the 59 applications we reviewed actually had no repairs or improvements that were related to the hurricane. (The other 53 applications had both hurricane and non-hurricane related repairs and improvements.) Thus, there was no need in these instances to allocate repairs and improvements between those related and those unrelated to the hurricanes. When we visited one of the six applicants, she confirmed that the repairs and improvements were not as a result of the hurricanes. In fact, she was surprised when we mentioned hurricane damage.

Lastly, we found that field officials routinely added non-hurricane related repair and improvement items to applications when they visited applicants' homes. Thus, it would not have been difficult or costly to allocate funds between hurricane and non-hurricane related items. According to applicants we met with, field officials routinely added non-hurricane repairs and improvements to applications. In some instances, they persuaded applicants to add items to applications even though the applicant did not request them. For example, one applicant told us that he did not ask for, or want, the new tub, shower, sink, and commode that the field official added to his application.

To prevent the types of problems profiled in this finding from occurring in future disasters, RHS officials should obtain a formal OGC opinion about the use of emergency funds, as it relates to applicable statutes, prior to allowing field staff to approve applications. Further, RHS officials should develop procedures for field staff to follow when approving applications after disasters strike.

Recommendation 4

Obtain a formal OGC opinion regarding the appropriate use of emergency funds prior to approving applications for future disasters.

Agency Response

Agency officials do not agree that it is necessary to obtain a formal OGC opinion regarding appropriate use of funds for each future disaster because it inhibits the process of providing essential assistance in a timely manner.

OIG Position

Our audit results indicate that a significant amount of emergency funds that were earmarked for damage related to the disaster were actually used for repairs and improvements unrelated to the hurricanes. This occurred because agency officials were unsure of the legislative restrictions related to the use of emergency appropriations. In our view, an OGC opinion would clarify any questions related to how funds should be used, and could be obtained more quickly than normal in a disaster situation. An OGC official indicated as much at the exit conference. Thus, we can accept management decision when agency officials agree to obtain a formal OGC opinion regarding the appropriate use of emergency funds prior to approving applications for future disasters.

Recommendation 5

Develop procedures that provide guidance to field staff on the proper use of emergency funds after disasters.

Agency Response

RHS officials are modifying agency handbooks to provide guidance to field staff on the proper use of emergency funds in future disasters. However, the officials indicated that they do not plan to revise the current program application process, which requires agency field staff to inspect property and develop a complete list of eligible and needed repairs. Thus, a repair list could include items unrelated to a disaster and not requested by a client.

OIG Position

The legislation related to the Gulf Coast disaster stated that emergency funds were to be used to repair hurricane damage. It is unknown at this time if legislation related to future disasters will include such stipulations. However, it is our view that agency policy and procedures related to future disasters adhere to applicable legislation at the time. To reach a management decision for this recommendation, agency officials need to include such provisions to differentiate between disaster and non-disaster repairs into their disaster guidance.

Section 2 Controls Over Disbursement of Funds

During our visits to six field offices in Louisiana and Mississippi, we found instances where field staff did not follow established agency procedures. Specifically, we noted that: (1) grant funds were used for prohibited types of repairs and improvements; (2) staff had not detected that unlicensed contractors were making repairs involving grant funds; and (3) there was no separation of duties between the loan and grant origination process, and the approval process. We attributed our findings to the need for improved monitoring by the State and national offices, as well as the need for procedures that describe specific actions for field staff to follow during a disaster. The findings resulted in some improper payments and increased the risk that some disaster victims who applied for assistance from Rural Development were unable to obtain needed funds to repair damage caused by the hurricanes.

Finding 4

Ineligible Repairs and Improvements

Almost 59 percent (37 of 63) of the grant applications we reviewed in two Mississippi field offices included repairs and improvements not related to health, safety, or handicap accessibility, as required by program regulations. Agency officials stated that emergency funding was to be used for economic recovery in the disaster area. Thus, they provided as much assistance as possible to eligible individuals, and did not consider other program requirements for those funds. State and national officials had not visited field offices in the disaster area prior to our review and, therefore, were unaware of the ineligible items. The 37 applications in our review included almost \$69,000 of ineligible repairs and improvements.

None of the unnumbered letters issued by the national office after the hurricanes instructed field staff to disregard normal program procedures regarding the use of grant funds. Thus, in our view, field office staff in the disaster area should have been adhering to all Rural Development Handbook requirements.³ The handbook states that grant funds must be used to remove health and safety hazards or to remodel dwellings to make them accessible and useable for household members with disabilities. It provides specific examples of ineligible repairs and improvements including the purchase and installation of equipment such as washers, dryers, and ranges; the construction of walkways or driveways; and the construction of new dwellings.

³ HB-1-3550, Paragraph 12.2 Eligible Purposes for 504 Funds [7 CFR 3550.102].

We analyzed completed repair lists⁴ for 63 grant applications totaling \$872,857 at two field offices in Mississippi. (We did not review repair grants in Louisiana because there were few repair funds being distributed in the State at the time of our review.) At the time, those two offices had approved 111 applications totaling \$1,312,041.

Our review disclosed 68 repair and improvement items listed on 37 applications that, in our view, were ineligible according to the agency's handbook and should not have been approved by field officials. Those 68 items totaled \$68,690. There were other ineligible repair list items that were also approved by field staff. However, not all repairs and improvements were completed; some items were removed (by the applicant) from the repair list in order to remain within the applicant's \$15,000 grant eligibility limit.

The type of items we questioned were either specifically listed as an ineligible item in the agency's handbook or, in our view, clearly fell within the guidelines listed in it. For example, we found 25 instances where appliances such as washers, dryers, and ranges were on the repair list to be purchased and/or installed. (These items were specifically listed as an ineligible item in the agency's handbook.) We also identified 27 instances where repair funds were approved to make cosmetic improvements such as installing ceiling fans, wall cabinets, and crown molding in applicants' homes. None of these improvements involved a health, safety, or handicap accessibility issue.

We also identified nine instances where field staff approved prohibited site preparations, remodeling, and additions to dwellings. These improvements ranged from pouring a concrete sidewalk from a carport to a utility room, to building additions to an existing structure. One recipient was approved to remove a utility room from the back of the house and build a new one inside the kitchen. The old utility room was to be destroyed and removed from the premises. Another recipient removed a bathroom wall to install a window. A third recipient was approved to remove an existing carport and rebuild a new one in its place, including an extension of the concrete driveway and the roof.

One field official informed us that since emergency funding was to be used for economic recovery in the disaster area, they placed as many items on the repair lists as possible within an applicant's funding limit. He added that field staff was trying to assist poor recipients in these areas who would otherwise not have been able to make these improvements. We visited numerous applicants and witnessed firsthand the poor living conditions that many lived in. However, while we can understand why field staff wanted to

⁴ The agency form prepared by field staff that lists all approved repair and improvement items to be submitted to contractors for bids.

help those individuals, they should not have disregarded normal program regulations by approving prohibited repairs and improvements. When we provided details of our findings to State officials, they agreed that the improvements did not appear to be related to health, safety, or handicap accessibility and, therefore, should not have been allowed by field officials.

After the Gulf Coast disasters, State and national officials adhered to their standard monitoring routine, which requires reviews of field offices. In one State, agency officials did not conduct a field visit in the disaster area until August 15, 2006. Further, they did not visit the field office with the greatest number of closed applications until early October 2006. If they had performed reviews prior to processing applications, they may have detected and disapproved the ineligible items. To prevent this problem in the future, RHS should develop procedures to monitor field office activities shortly after disasters strike.

Recommendation 6

Establish procedures to monitor field office procedures immediately following a disaster.

Agency Response

Agency officials concurred that monitoring procedures were needed for future disasters. They intend to issue guidance that will outline procedures and processes that State officials will use to more closely monitor field office activities.

OIG Position

We agree with the agency officials' proposed corrective actions. To reach a management decision, they need to provide us with timeframes for completing the corrective actions.

Finding 5

Repairs Performed By Non-Licensed Contractors

Loan and grant recipients in Mississippi used unlicensed contractors to repair damage caused by the hurricanes, which violated agency regulations and State law. In our review, about 30 percent (13 of 44) of the approved applications that exceeded \$10,000 involved the use of unlicensed contractors. Agency field staff had not detected the unlicensed contractors because they either did not seek verification with the responsible State agency, or did not check the appropriate page on the State agency's website. Also, RHS did not have procedures that provided direction to field staff when requesting information from contractors, and on how to use that information to verify that contractors had valid and up-to-date licenses. Consequently, agency officials had approved almost \$209,000 for the 13 applications involving unlicensed contractors.

According to agency requirements, repairs funded by Rural Development grants must be completed in accordance with local laws. In Mississippi, the Board of Contractors Residential Builders' Law requires contractors making repairs that exceed \$10,000 be licensed by the State or have a valid license from a reciprocal State.⁵ It also requires contractors to renew their licenses annually.⁶ The use of licensed contractors is important because it decreases the risk of substandard repair work and fraud. It also increases the likelihood that contractors are properly insured.

As news accounts have shown, many unlicensed contractors have been involved in disreputable activities in the Gulf Coast region. In fact, one recent article stated that the Mississippi Attorney General's Office was investigating 264 cases of fraud involving unlicensed contractors. While the use of licensed contractors does not eliminate the risk of substandard work, or that fraud will be committed, it does reduce the likelihood of these problems. For this reason, most States have enacted contractor licensing laws.

Since the damage caused by the hurricanes was extensive, it significantly increased the demand for licensed contractors in the Gulf Coast region. In some areas, the demand was much greater than the number of licensed contractors, which resulted in lengthy delays to repair damage. Because of this, we were concerned that applicants would have difficulty finding contractors who were licensed to make housing repairs and, ultimately use unlicensed contractors. Accordingly, we examined 44 repair loan and grant applications that exceeded \$10,000 in Mississippi, and totaled \$720,731, to

⁵ Reciprocal States include Louisiana, Arkansas, Tennessee, South Carolina, and Alabama.

⁶ Section 1 73-59-1 and Section 2 73-59.

determine if contractors approved to perform repairs involving agency funds were properly licensed. At the time of our visit, those offices had approved 111 applications totaling \$1,312,041. Although Louisiana was also significantly impacted by the hurricanes, we did not examine grant applications because there were few repair funds being distributed in the State at the time of our review.

We contacted the Mississippi State Board of Contractors to verify that the 44 contractors listed on the applications in our review were licensed by the State. We found that recipients for 13 of the 44 applications were using unlicensed contractors to make repairs. The repairs for those 13 applications totaled \$208,732. On July 18, 2006, we notified field officials of our findings. They immediately stopped processing 11 applications involving unlicensed contractors. Unfortunately, funds totaling \$27,634 had already been disbursed to unlicensed contractors for the other two applications.

We identified most of the unlicensed contractors during our review at one field office. Officials from that office told us they were verifying licenses with the State Board of Contractors. However, we were unable to locate any evidence in the case files that supported verification of contractor licenses. In fact, when we verified licenses from that office with the State Board, we found 11 of the 13 instances where unlicensed contractors were being used to make repairs. In contrast, we visited another field office that printed copies of license information, such as the license number and date of expiration, from the State Board and included it in case files. Not surprisingly, we found no instances at that office where unlicensed contractors were being used to make repairs.

When officials at the third field office checked the State Board's website, they did not search beyond the site's main page. Because the main page listed contractor names, license numbers, addresses, and phone numbers, the officials assumed the contractors had valid licenses. However, had they followed a link to another page in the system, they would have found more detailed information on the requested contractors, such as the expiration dates of their licenses. Our review of the detailed information disclosed one instance where the contractor's license had expired and another where the license had been revoked.

We also found that the 3 field offices were using 13 different versions of the agency's repair list to obtain contractor information. As a result, essential contractor information such as license numbers, addresses, and telephone numbers were often missing from repair lists. For example, the repair lists for 12 of the 13 applications where we found unlicensed contractors did not list the contractor's license number. In our view, a contractor's full name,

business name, license number, address, and phone number, should always be maintained to ensure adequate verification of a contractor's license.

To ensure that these problems do not occur in future disasters, RHS should require all licenses to be verified with the State agency responsible for licensing contractors and provide guidance to field staff on how to perform this action. The guidance should include procedures and tips designed to assist staff searching State Boards of Contractors' websites, and for calling State Boards to verify contractor licenses. Further, all case files should include a copy of contractors' license numbers and expiration dates.

During the course of our review, we searched several State Boards of Contractors on the Internet. We found that regardless of the State, we were able to confirm that the contractors' licenses were current with minimal difficulty. In fact, most websites were very easy to navigate, and allowed us to quickly identify contractor license information. RHS should provide this information to field staff.

While we consider detecting unlicensed contractors to be very important, we also acknowledge that applicants may have difficulty finding licensed contractors after a disaster. For instance, as of September 27, 2006, over 2 months after we informed agency officials about the 11 unlicensed contractors, only 6 applicants had found licensed contractors who could legally perform repairs. The remaining five applicants were still searching for licensed contractors.

The search for, and verification of, licensed contractors, could be a difficult endeavor for field staff during a disaster situation. However, this may be mitigated by contractors that come from other States to work in disaster areas. We noted numerous such instances, and generally found that many of those contractors were licensed in the State where they came from. In fact, for the two applications in our review where funds were disbursed to unlicensed contractors, one was licensed in Florida, and the other in Michigan. Unfortunately, neither was from reciprocal agreement States.

Our analysis did find that while States have varying licensing requirements, most maintain that contractors are properly insured, and are capable of providing services that comply with established building code standards. The only difference we could ascertain between States was the contract cost where a license was required. For example, the State of Florida required all contractors be licensed regardless of the contract amount, while the State of North Carolina required contractors to obtain a license on projects of more than \$30,000. In our view, since States generally had similar requirements, it would not be difficult for those contractors to obtain a license in the State where a disaster occurs. However, field offices would have to maintain and

provide information to contractors about their States' licensing application procedures.

Recommendation 7

Require field officials, where applicable, to verify all contractor licenses.

Agency Response

Agency officials are developing guidance for field staff to use when verifying that selected contractors meet applicable State and local licensing requirements. The agency handbook will also be amended to require that contractors have a valid State contractor's license and that the loan originator obtain verification of such license.

OIG Position

We agree with the agency officials' proposed corrective actions. To reach a management decision, they need to provide us with timeframes for completing the corrective actions.

Recommendation 8

Develop guidance and procedures, where applicable, for field staff to use when verifying contractor licenses through a State Board of Contractors (either through a website and the telephone), and for documenting verification in case files.

Agency Response

Agency officials are developing guidance for field staff to use when verifying that selected contractors meet applicable State and local licensing requirements. The agency handbook will also be amended to require that contractors have a valid State contractor's license and that the loan originator obtain verification of such license.

OIG Position

We agree with the agency officials' proposed corrective actions. To reach a management decision, they need to provide us with timeframes for completing the corrective actions.

Finding 6

Separation of Duties Lacking for Loan and Grant Processing

Disaster funds distributed in Mississippi were vulnerable to misuse because field staff had not followed guidelines related to the duties of their position (loan and grant originators versus approvers). At two of the three offices we visited, all loan and grant applications we examined were received, reviewed, and approved by the same employee. Field staff stated that agency policy did not specifically require the separation of those duties. As a result, errors or worse, questionable activities, could go undetected by agency managers.

Rural Development Handbook Section 1-3550 states that loan originators are responsible for conducting preliminary screening procedures to determine if applicants qualify for loans and grants, and that applications are complete. Loan originators make formal determinations of an applicant's eligibility by verifying household income, checking credit history (for applications involving loan requests), and reviewing all other eligibility requirements. If an applicant is eligible for a loan or grant, then the case file is to be submitted to a loan approval official for review and approval. Upon approval, loan originators obligate funds and notify applicants. However, while the handbook describes the duties of individual positions, it does not specifically require that they be separated among different staff members.

We visited six field offices in Mississippi and Louisiana to verify that field staff were processing loan and grant applications in accordance with agency requirements. None of the unnumbered letters issued by the national office after the disaster instructed field staff to disregard normal program procedures related to processing loan and grant applications. Thus, in our view, field office staff in the disaster area should have been adhering to existing handbook requirements.

At field offices, we questioned staff about the procedures they were using to process applications, and reviewed case files for 95 loan and grant applications. At two of the three field offices we visited in Mississippi, we found that each staff member was responsible for accepting, reviewing, and approving his or her own set of assigned applications. The separation of duties is an internal control that, when not followed, significantly increases the risk that errors or questionable activities could occur and not be detected by agency managers. While we did not find any instances of irregularities during our limited tests, we did find two errors that went undetected until we notified agency officials.

The first error involved a \$3,500 grant that was mistakenly input into the system by a loan originator for \$12,500. We notified the State office of the

mistake before funds were obligated for the incorrect amount. However, when we checked the system again two months later, we found that the grant had been obligated for the incorrect amount of \$12,500. The second error involved an applicant's eligibility for a loan and grant package totaling \$18,375. Our review of the case file for this application disclosed that the recipient had been seriously delinquent on numerous accounts for over a year prior to the disaster. For example, prior to the disaster, the recipient was 30 to 60 days delinquent on her mortgage payments for 20 consecutive months and over 90 days delinquent for 13 consecutive months on another account.

To be eligible for loans, applicants cannot have a history of delinquent credit, including accounts that are more than 30 days delinquent on two or more occasions during a 12-month period. When we brought this to the attention of field officials, they stated that credit reports were not required for grant approvals, and since most of the funds were from a grant, the delinquencies were not problematic. However, when we questioned a State official, he stated that even though a credit report was not required, the loan should not have been approved because the one obtained had revealed the applicant's poor credit history. The State official added that field staff should have documented their reasons for approving the loan. We found no such documentation in the case file. In our view, better controls, such as the separation of duties and a second party review, would have increased the likelihood that this application was properly processed by field officials.

Field officials informed us that they were performing all aspects of the application process because of the high volume of applications that had been submitted to the agency. Several officials stated that the agency waiver raising the rural area designation from 20,000 to 50,000 (and up to 75,000 in some areas) significantly increased the number applications submitted to the agency.⁷ Therefore, in field officials' view, it was more efficient for one employee to perform all functions from acceptance to approval. In this way, they could expedite application processing, which would benefit individuals who needed assistance quickly after the disasters. They added that the handbook did not specifically require these duties to be separated among different employees.

The number of applications submitted to the three Mississippi offices did increase dramatically after the disaster. For example, the three field offices in Mississippi hardest hit by the hurricanes normally process about 25 applications per year. However, as of February 27, 2006 (approximately six months after the disaster), those offices had processed an average of 1,676 applications. While we understand their position, we still maintain our

⁷ Gulfport and Biloxi, Mississippi, and Kenner, Louisiana.

view that sufficient controls should be in place to prevent and detect errors and questionable activities.

At the offices we visited in Mississippi, there was sufficient staff to separate duties. If the acceptance, review, and approval of each file had been delegated to more than one staff member, the separation of duties would not have, in our view, delayed processing. In fact, it may be more important to separate duties after a disaster because the volume of applications being processed would make it easier for an error to occur, and more difficult to detect errors or fictitious applications.

We did not find this control weakness in Louisiana even though there was only one staff member in each field office we visited. In that State, loan originator's in field offices collected documents from applicants and performed analyses to determine eligibility. If deemed eligible, the application was sent to an area office where a technician (loan approval official) performed a second-party review of the case file. If approved, the application was electronically sent to the State office for obligation. Thus, even without a specific handbook requirement to separate duties, employees did so, and overcame the problem of insufficient staff within individual offices. Plus, there was no apparent delay in processing applications.

The Government Accountability Office in its "Internal Control Standards" states that key duties such as authorizing, processing, recording, and reviewing transactions, as well as handling any related assets, need to be segregated among different individuals to reduce the risk of errors or fraud. It specifically states that one individual should not control all aspects of a transaction. In our view, RHS should revise its policy to clearly require the segregation of duties between loan and grant originators and approvers.

Further, it should develop procedures that describe alternative ways to separate duties during a disaster, taking into consideration the number of staff members in field offices, along with the potential increase in application activity.

Recommendation 9

Require the separation of duties between loan and grant originators and approving officials, and develop procedures for those individuals to follow during a disaster.

Agency Response

Agency officials have already taken general steps to require separation of duties for originators and approval officials. They have required approval officials to identify who verified the borrower's income and credit, obligated funds in the system, and activated the loan. They have also required that each of these functions be performed by someone other than the approval official. In addition, State Internal Review guides have been modified to include steps to verify these requirements are followed by field staff.

OIG Position

We accept management decision for this recommendation. Final action can be reached by advising the Office of the Chief Financial Officer that this action is part of agency procedures.

Section 3 Asset Management

Finding 7

Potential Losses Unknown for Direct Housing Portfolio

Rural Development officials had not identified borrower accounts (direct loans) in the disaster area that were in jeopardy of default, or the number and cost associated with uninhabitable properties that would likely need to be destroyed. In our estimation, 59 percent of the properties we visited (79 of 135) in Louisiana were in jeopardy of default. Also, 91 percent (123 of 135) of those properties were uninhabitable and would need to be demolished or require major rehabilitation.⁸ Those properties had Section 502 loan balances of almost \$4.7 million.⁹ According to an agency official, they were waiting until after the moratorium period ended, which was August 31, 2006, to assess these conditions.

Immediately after Hurricane Katrina, RHS officials waived numerous program requirements to assist borrowers negatively impacted by the disaster. On September 26, 2005, RHS officials issued a letter that included a moratorium on loan account payments for direct loans. The moratorium

⁸ These properties were located in some of the hardest hit areas of Louisiana.

⁹ Of the \$732 million in the disaster areas.

was authorized to be automatic, without application, for all borrowers in the disaster area. It was originally established for a six-month period. However, it was extended and a significant number of the accounts we reviewed (58 of 135) were still on a moratorium as of September 2006.

We were concerned that the moratorium, since it was automatic and did not involve contact with borrowers, might conceal the fact that many borrowers did not intend to repay their loans. In our view, those accounts should be identified as soon as possible to avoid unnecessary losses to the loan portfolio. Because of this concern, we visited 135 agency-financed properties in some of the hardest hit areas in Louisiana, with outstanding Section 502 loan balances of almost \$4.7 million, to observe conditions and meet with homeowners, if possible, and determine if they intended to remain in their homes. We made those visits in April 2006.

As a result of our visits to agency financed properties, as well as discussions with agency officials, we identified two issues that need to be addressed. The following sections describe our concerns.

Classification of Accounts

Our first concern involved the proper classification of direct loan accounts that were granted moratoriums. We found that agency officials had not questioned most borrowers about their intentions to repay loans even though they had contact information for a significant number of borrowers. When we discussed this with RHS officials, they stated that file notes are maintained for each account, which should document contacts with borrowers. Our analysis of notes for the 138 borrower files we examined disclosed that 111, or 80 percent, had contacted agency officials after the hurricanes and left a forwarding mailing address. However, there was no evidence in the notes that agency officials had questioned borrowers about their future intentions or, if they were undecided, given instructions about how to proceed when they determined a future course of action.

Agency officials did send packets to borrowers after the hurricanes to determine if they wished to remain on a moratorium or re-amortize their loans. However, only 19 percent (26 of 138) of the borrowers in our review had completed and returned their packets. Some packets were returned as undeliverable because the agency sent them to the borrowers' homes, rather than to a forwarding address.

During our visits to properties, we found that most borrowers were not living in their homes. Those still present, about 38 percent of the properties we visited, were generally living in FEMA trailers. For those not living on the properties, some had left contact information, such as telephone numbers or

forwarding addresses. Generally, borrowers had painted this information on the front door or the front of their homes. However, because agency officials had not visited any of the properties, they had not seen this information.

Several of the borrowers we met with told us that they wanted to rebuild their homes. However, they were not able to because either insurance proceeds were insufficient to cover all damage or the local municipality had temporarily prohibited construction in the area. Thus, many were unsure of the future, which would include making payments to Rural Development after expiration of the moratorium period.

The two States we visited, Mississippi and Louisiana, created grant programs that assist homeowners who suffered damage from the hurricanes. Those programs provide grants of up to \$150,000 to eligible homeowners. Our analysis indicates that the borrowers we met with would be eligible for State grants. However, agency officials were not aware of borrower intentions because they had not contacted them. More than a year after the Gulf Coast disaster, agency officials still did not know most borrowers' intentions for their property.

The determination of borrower intentions is critical to classifying accounts, estimating losses, and planning future actions after a disaster. Agency officials were aware of this fact when they required lenders and servicing holders to report such information in a December 6, 2005, letter. The letter stated that on or before March 31, 2006, loan holders and servicing companies had to perform the following actions: (1) assess the status, condition, and habitability of the mortgaged property; (2) establish contact with impacted borrowers and evaluate their short term and long term plans for housing, employment, home repairs and repayment of the mortgage debt; (3) determine borrowers' hazard and flood insurance coverage, property damage and available insurance recoveries; and (4) confirm in writing that borrowers intend to work with the holder or servicing company to develop and implement a plan to repair or rebuild the home and resolve the mortgage delinquency.

Even though agency officials required lenders to submit critical information about damage and homeowner intentions for guaranteed loans, they had not obtained similar information for the Direct Loan Program. However, Rural Development had estimated losses for the Guaranteed Loan Program to be \$3.5 million. (This is out of almost 6,000 loans, totaling about \$491 million, in the disaster area.) While we did not contact lenders or review the underlying rationale for the Guaranteed Loan estimates, it does demonstrate the need to obtain such information.

At the exit conference, agency officials stated that they had monitored direct loan account activity immediately after the hurricanes and throughout the disaster period. They subsequently provided reports and documents that listed information such as the total number of accounts in the disaster areas, the amount of unpaid loan balance for those accounts, and the amount of insurance claim reimbursements associated with those accounts. They also included an analysis performed on March 20, 2006, of projected losses based on prior year hurricane damage in Florida, which had been previously provided to us in September 2006 by CSC's Deputy Director. However, that analysis, as well as the other documents provided by agency officials, did not identify borrower accounts in the disaster area that were in jeopardy of default, or indicate that agency officials had attempted to make such a determination. Specifically, we were looking for the same information that agency officials required lenders participating in the Guaranteed Loan Program to obtain in a December 6, 2005, letter.

Uninhabitable Property

We found that 123 of the 135 properties we visited in Louisiana, with outstanding Section 502 loan balances of almost \$4.7 million, were, in our view, uninhabitable or would require major reconstruction to be inhabitable in the future. Most of the properties we observed had extensive water damage to the interior of the homes. Some were in such poor condition that they would have to be gutted or destroyed. In fact, one property had already been demolished and was lying in a pile of debris by the street.¹⁰

Agency officials had not inspected any of the properties we visited to assess damage and determine a future course of action that would reduce losses to the Government. According to agency officials, they were waiting until the moratorium period ended to determine the status of borrower accounts. At that point, they would know borrowers' intentions, which might include returning to the property and making payments, payoff of the loan, or default on the loan.

Our concern is that the longer agency officials wait to acquire abandoned properties, the more it will cost to either rehabilitate or demolish them. In fact, it might be very costly to restore some properties to livable condition. For instance, we found that the soil was contaminated at many of the properties we visited. Those properties were in areas where entire subdivisions may have to be demolished, and the soil reconditioned before homes can be rebuilt. A national official informed us that the agency was considering releasing the mortgages on properties of that nature, which would

¹⁰ See Exhibit B for photographs of properties.

effectively limit the loss to the outstanding loan balance. However, the agency had not yet formulated a plan on how to handle these conditions.

During the course of our audit, we met with national officials who stated that the agency was considering the development of formal guidance to address the issues in this finding for future disasters. In our view, this task should be undertaken to ensure that field staff clearly understand the measures to be taken to prevent unnecessary losses.

Recommendation 10

Develop policy and procedures for contacting borrowers after future disasters to classify borrower accounts and handling uninhabitable property at the least cost to the agency.

Agency Response

Agency officials agreed that procedures should be developed to contact borrowers and assess damage as soon as possible after a disaster. They stated that their Disaster Preparedness Binder and Disaster Management Action Plan provided guidance on servicing protocol during disasters that adequately addressed OIG concerns for future disasters.

OIG Position

We reviewed the agency's Disaster Preparedness Binder and Disaster Management Action Plan. In our view, it did not address some procedures that are important when determining the proper classification of an account after a disaster. Those procedures should include steps to (1) assess the status, condition, and habitability of property; and (2) contact impacted borrowers to obtain insurance recovery estimates, and to determine their plans for repairing damage and making loan payments. To reach a management decision for this recommendation, agency officials need to include such provisions in their disaster guidance.

Scope and Methodology

We conducted our audit of RHS' activities related to the Gulf Coast hurricane disasters at its national office in Washington, D.C., the Mississippi Rural Development State Office, three local offices in Mississippi, and at three local offices in Louisiana. We also contacted officials at the Louisiana Rural Development State Office and at the Centralized Servicing Center (CSC) in St. Louis, Missouri. Further, we observed the physical condition of 177 single-family homes in the States of Mississippi and Louisiana, and met with 35 homeowners. (There were no homeowners present to meet with at 142 properties.) The majorities of those properties, 135 had been originally financed by Rural Development and were participating in the SFH Program. The remainder, 42, had applied for Section 504 repair loans and grants.

We judgmentally selected the properties we visited from the geographical areas that suffered the most damage, and where the greatest numbers of applications were being received by Rural Development. The period of review was from September 1, 2005, the retroactive date when RHS began taking applications for housing assistance after Hurricane Katrina, through August 31, 2006. This period includes the date, March 13, 2006, when Rural Development announced the availability of hurricane disaster assistance pursuant to chapter 1 of title I of Division B of the Department of Defense, Emergency Supplemental Appropriations to Address Hurricanes in the Gulf of Mexico and Pandemic Influenza Act (the "act").

The act authorized Rural Development to provide almost \$1.3 billion and \$176 million in guaranteed and direct loans, respectively, to homeowners affected by hurricane damage in the designated disaster areas. (At the time of our audit, agency officials had not disbursed much of these funds. Thus, we did not examine the propriety of guaranteed and direct new loans, including the eligibility of loan recipients.) It also authorized Rural Development to provide over \$34 million and \$20 million in repair loans and grants, respectively, to respond to damage caused by the disaster.

As of September 30, 2006, Rural Development had obligated \$179,742,190 in guaranteed loans, \$80,627,941 in direct SFH loans, \$2,626,864 in repair loans, and \$15,127,127 in grants. The 135 properties that we visited in Louisiana had received almost \$4.7 million in Section 502 loans from Rural Development prior to the disaster. The 42 applicants from Mississippi received \$311,740 in emergency housing assistance since the disaster. (This included \$35,351 in loans and \$276,389 in repair grants.)

To accomplish our objectives, we performed the following procedures:

- Reviewed applicable laws, regulations, and guidance related to the SFH Program, including special guidance related to the disaster;
- Reviewed Rural Development's policies, procedures, and management controls over the process of approving applications for SFH Program loans and grants, and for monitoring field office activities in this area;
- Reviewed Section 502 (Direct and guaranteed) loan files in Louisiana;
- Reviewed Section 504 repair loan and grant files in Mississippi;
- Interviewed agency officials to determine the guidance and direction given to loan and grant applicants impacted by the disaster, and the monitoring actions they took to ensure that applicants complied with prescribed guidelines;
- Interviewed loan and grant applicants to confirm that information provided to the agency was accurate and complete, to determine if they had received housing assistance from other Federal agencies or other sources such as insurance companies or charitable organizations, and to determine if they fully understood the SFH Program rules; and
- Visited properties financed by Rural Development prior to the disaster to determine the condition of the agency's loan portfolio, and to verify that repair loans and grants had been used for eligible purposes and for disaster related damage.

We also obtained the names and addresses of all agency borrowers in the declared disaster area from the officials at the CSC. In addition, they provided the names of all borrowers on moratorium, a list of all real estate owned property in the disaster area, all claim amounts for the area, and the running records (file notes) for the 138 loan and grant files in our sample.

We conducted our fieldwork from April through August 2006. Our audit was conducted in accordance with *Government Auditing Standards*.

Exhibit A – Summary of Monetary Results

Exhibit A – Page 1 of 1

Finding Number	Description	Amount	Category
3	Emergency funds provided for repairs and improvements not related to hurricane damage.	\$320,152	Funds to be Put to Better Use
4	Emergency funds provided for repairs and improvements that were prohibited by program regulations.	\$68,690	Funds to be Put to Better Use
TOTAL		\$388,842	

Exhibit B — Photographs of Damage to Agency Financed Housing

Exhibit B – Page 1 of 3



Louisiana home, gutted after the disaster. Borrower contact information painted on the home.



Louisiana home completely demolished as a result of Hurricane Katrina.

Exhibit B — Photographs of Damage to Agency Financed Housing

Exhibit B – Page 2 of 3



Abandoned home in Louisiana with contact information.



Abandoned home in Louisiana.

Exhibit B — Photographs of Damage to Agency Financed Housing

Exhibit B – Page 3 of 3



Abandoned home in Louisiana.



Mildew and mold cover the walls and furniture of a Louisiana home.

Exhibit C – Agency Response

Exhibit C – Page 1 of 10



United States Department of Agriculture
Rural Development

MAR 28 2007

SUBJECT: Office of Inspector General – Controls over Single Family Housing
Funds Provided for Hurricane Relief Efforts (Audit No. 04601-015-CH)

TO: Robert W. Young
Assistant Inspector General
for Audit
Office of Inspector General

Attached for your review is Single Family Housing's response dated March 23, 2007, to the official draft for the subject audit.

This response is being submitted for inclusion in the final report and your consideration to reach management decision on the recommendations.

If you have any questions, please contact Arlene Pitter of my staff at 202-692-0083.

A handwritten signature in black ink that reads "Walter Wright". The signature is written in a cursive, flowing style.

WALTER WRIGHT
Acting Director
Financial Management Division

Attachment

1400 Independence Ave, S.W. · Washington DC 20250-0700
Web: <http://www.rurdev.usda.gov>

Committed to the future of rural communities.

"USDA is an equal opportunity provider, employer and lender."
To file a complaint of discrimination, write USDA, Director, Office of Civil Rights,
1400 Independence Avenue, S.W., Washington, DC 20250-9410 or call (800) 795-3272 (Voice) or (202) 720-6382 (TDD).

Exhibit C – Agency Response

Exhibit C – Page 2 of 10



United States Department of Agriculture
Rural Development

MAR 23 2007

TO: John Dunsmuir
Acting Director
Financial Management Division

FROM: David J. Villano
Deputy Administrator
Single Family Housing

THROUGH: Russell T. Davis
Acting for Administrator
Housing and Community Facilities Programs

SUBJECT: Office of Inspector General (OIG) Audit No. 04601-015-CH
Controls over Single Family Housing (SFH) Funds
Provided for Hurricane Relief Efforts

We appreciate the opportunity to provide comments to the subject Audit Report.

As with other Americans, USDA Rural Development staff were shocked by the devastation to the Gulf area caused by Hurricanes Katrina and Rita in late summer 2005. Before the winds had fully subsided, employees from Rural Development offices nearby and from around the country, were pitching in to help.

In the storm's aftermath, Rural Development's Centralized Servicing Center (CSC) immediately went into action. Moratoriums were placed on more than 24,000 accounts in the impacted areas, providing borrowers a temporary, needed measure of relief from payments. CSC made some 58,000 calls to storm ravaged families, discussing loan servicing actions. Nearly 4,000 insurance claims totaling more than \$22 million were processed. A FEMA call center run from CSC received about 73,000 calls, assisting families with relocation and other concerns.

Local Rural Development employees worked more than 70,000 hours in 100 Disaster Recovery Centers. Offices that typically processed a small number of applications each year were inundated with thousands of requests for home repair assistance and an opportunity to start anew.

1400 Independence Ave, SW - Washington, DC 20250-0700
Web: <http://www.rurdev.usda.gov>

Committed to the future of rural communities.

"USDA is an equal opportunity provider, employer and lender"

To file a complaint of discrimination write USDA, Director, Office of Civil Rights, Room 326-W, Whitten Building, 14th and Independence Avenue, SW, Washington, DC 20250-9410 or call (202) 720-5964 (voice or TDD).

Rural Development offices around the country worked to place newly homeless families in Rural Development financed Multi-Family Housing units. Some families found shelter in Rural Development Real Estate Owned (REO) properties - as far away as Montana and Michigan. Rural Development teams were detailed to the region to get offices up and running and to assist with the onslaught of applications.

Those in the National Office worked closely with State staff, finding new ways to use existing programs to meet this unprecedented housing challenge.

It is with a high degree of satisfaction for Rural Development's overall efforts that we respond to this OIG audit. The storms and Rural Development's response are unprecedented. The careful review and constructive criticism of this response by OIG provides the best measure of the success of Rural Development's effort. This report provides a valuable tool as we plan for future responses to disasters. We appreciate this valuable effort by OIG.

Finding 1 Coordination with other Federal Agencies Before and After Providing Assistance.

Recommendation 1 – Include the SFH Program in the computer matching agreement currently being developed with HUD for multi-family housing, and with all subsequent agreements between RHS and the other Federal agencies such as FEMA and SBA.

RHS Response – Agree

SFH staff has already completed a revision of the proposed 'Matching Agreement between HUD and RHS to include SFH programs. Under the agreement, HUD systems of records will be compared with SFH records in the Dedicated Loan Origination and Servicing System (DLOS) and the Guaranteed Loan System (GLS), as well as the Multifamily Information System (MFIS). We expect the agreement to be executed by RHS and HUD within the next few months. This agreement has been reviewed by OGC and is in clearance within the MFH and SFH program staffs.

Any subsequent agreements between RHS and other Federal agencies such as FEMA and SBA will have similar matching agreements.

Finding 2 Insurance and Charitable Assistance Not Disclosed

Recommendation 2 – Develop policies that require field staff to query individuals about housing assistance received from other sources

3

during disasters, and procedures to identify assistance provided by those sources.

Recommendation 3– Require applicants to disclose any assistance from other sources, and certify that the applicant has provided all information under threat of criminal penalties.

RHS Response – Agree

RHS appreciates the input of the OIG team members in developing the memorandum issued to field staff on May 25, 2006. The memo provides guidance to states eligible for hurricane assistance on verification of other benefits. It pertains to insurance benefits as well as assistance, gifts or aid from other government agencies, relief organizations, charities, and any other source. It requires a reasonable effort to discover other possible benefits, including verification from mortgage holders and insurance providers. The memorandum requires applicants to certify by writing on the Form RD 410-4 and Form RD 3550-24 that no other payment or benefit of any kind has been or will be received for the same purpose.

The May 25, 2006 memorandum is being used to develop a new Guide or Attachment to the Direct Single Family Housing Programs Field Office Handbook (HB-1-3550) specifically for disaster assistance.

Finding 3 Funds Provided for Non-Hurricane Related Repairs

Recommendation 4 – Obtain a formal OGC opinion regarding the appropriate use of emergency funds prior to approving applications for future disasters.

RHS Response – Does Not Agree

Rural Development does not agree that it is necessary to obtain a formal OGC opinion regarding appropriate use of funds for each future disaster. We believe that such consultation adds an unnecessary step to the process of providing essential assistance and creates the opportunity for unnecessary delays. One of the most important recovery efforts after a disaster is sheltering victims. OIG's recommendation is contrary to the urgent nature of Natural Disaster assistance programs.

It is noted (and cited in the Report) OGC guidance was obtained and followed in this regard after the 2005 hurricanes. It should

4

remain the prerogative of the Administrator and management officials to obtain legal counsel as needed.

Recommendation 5 – Develop procedures that provide guidance to field staff on the proper use of emergency funds after disasters.

RHS Response – Does Not Agree

Assistance provided must meet the requirements of the enabling legislation. We fully intend to provide guidance to the field on the proper use of emergency funds in future disasters. Changes are underway to the Direct Single Family Housing Programs Field Office Handbook (HB-1-3550) to provide guidance for all applications for disaster assistance.

However, Rural Development takes issue with OIG's assertion that funds were widely misused in this disaster for non-hurricane repairs. In general, the Section 504 Repair program application process requires the Rural Development official to inspect the property and develop a complete list of eligible, needed repairs. It is typical that the repair list could include items the client had not requested.

Further, we do not believe it was the intent of Congress in appropriating disaster funds that requests for assistance be split between disaster and non-disaster related items. This would create a hardship to the applicant and undue administrative burden on limited local staff to process 504 assistance separately using Natural Disaster and regular loan and grant funds and regulations. For example:

1. The inspector would need to determine which repairs are related to hurricane damage and which related to the condition of the home prior to the disaster. In many instances, it would be necessary to pro-rate repairs to disaster and non-disaster related factors for the same item or repair.
2. Applications would need to be funded with 2 or more sets of legal documents, including multiple promissory notes, grant agreements, etc. Customers would have two loan payments.
3. Funds would need to be segregated and tracked according to differing rules and purposes. This greatly increases the likelihood of errors and abuse.

5

4. Similarly, contractors providing bids would need to segregate the amounts to be covered by the differing programs and differing rules. This will discourage contractor participation and increase cost to cover this burden.

5. Funding coordination could be difficult, if funds were available for one funding source and not another. This problem would be compounded in cases where third party assistance was also provided.

6. Multiple Section 504 loans and grants would be required – up to four different if a loan-grant combination is approved for both disaster repairs and non-disaster essential repairs. It is likely that one or more of these funds would be depleted, disrupting repairs financed by other funds.

7. Overall management of the programs would be more difficult and costly at all levels within Rural Development.

Following are two likely unintended outcomes of OIG's recommendation.

Family A needs a porch replaced. The existing porch, which lacked the necessary handicap access for the family, was destroyed by the Hurricane. Two requests for assistance would need to be processed - one for replacement of the porch, and one for the added cost of making the home accessible. One contractor would need to supply two cost estimates for portions of the same porch. Two loans would be processed and tracked, two promissory notes would be executed, and the customer would need to make two loan payments for one porch.

Family B's roof was destroyed and needs complete replacement. The roof was ten years old and minor leaks were already evident in the home. A contractor would need to document the full cost of replacement of the roof and pro-rate the cost between the existing roof's depreciated value and the added cost due to destruction by the storm. Further assessment to interior damages would need to establish which costs would be prorated between the disaster and non-disaster related loans. Two loans would be processed. Further complicating this example could be a situation where Rural Development had fully utilized non-disaster related Section 504 loan funds, but had sufficient Section 504 disaster funds. In that case, Rural Development could not help this family at all since adequate funds were not available.

6

While we understand OIG's concern that disaster funds were used for essential home repairs that were not specifically related to the Hurricane, we believe the potential negative consequences to families in desperate need of decent, safe and sanitary housing, presents a logical interpretation of the Hurricane assistance Bill.

Finding 4 Ineligible Repairs and Improvements

Recommendation 6 – Establish procedures to monitor field office procedures immediately following a disaster.

RHS Response – Agree

We concur that this is needed for future disasters. One of the issues that make this more challenging than it may appear is that often immediately following a disaster there is very little application activity as most people are in a "recovery mode". When application activity does eventually pick-up or as was the case in this event, supplemental funding becomes available months later, it can be difficult to put monitoring procedures into effect during a time when the focus is on providing assistance to those in great need. We intend to issue guidance that will outline procedures and processes that State Offices will use to more closely monitor the activities of their field offices.

Regarding authorized uses of Section 504 loan and grant funds, we intend to modify the restrictions outlined in HB-1-3550 to allow the purchase of essential appliances (refrigerators and stoves/ranges) in presidentially declared disaster areas when it can be established that replacement of an existing appliance is necessary due to damage caused by the disaster.

Finding 5 Repairs Performed By Non-Licensed Contractors

Recommendation 7 – Require field officials, where applicable, to verify all contractor licenses.

Recommendation 8- Develop guidance and procedures, where applicable, for field staff to use when verifying contractor licenses through a State Board of Contractors (either through a website or the telephone), and for documenting verification in case files.

RHS Response – Agree

Guidance is being developed which will require Field staff to verify that selected contractors meet state and/or local licensing requirements for the cost and type of development to be completed. In HB-1-3550, Paragraph 5.25 will be amended to require the contractor must have a

7

valid state contractor's license if required in the state and that the Loan Originator should obtain verification of such license. In addition, the Loan Originator will be required to verify the license with the appropriate State entity and document the applicant's file. Licensing requirements vary widely among states and localities. Based on a recent internet search, nearly half of the states do not require licensing of general repair contractors. Further, some states do not require licensing on small repair jobs. Again, this threshold varies widely among states and is often above the average 504 repair cost. Each State should provide guidance regarding local licensing requirements.

Guidance is provided in HB-1-3550, paragraph 5.25 to assure unfamiliar contractors have adequate capability to perform construction and repairs *before approval*. Inspection of successfully completed work before payment also greatly reduces the risk of substandard repair work and fraud.

Finding 6 Separation of Duties Lacking for Loan and Grant Processing

Recommendation 9 – Require the separation of duties between local loan and grant originators and approving officials, and develop procedures for those individuals to follow during a disaster.

RHS Response – Agree

The Agency has already taken general steps to require separation of duties for originators and approval officials. Approval officials are required to identify who performed each of the following functions:

- Verification of the borrower's income and credit;
- Obligation of the funds in MortgageServ electronic system, and;
- Activation of the loan in MortgageServ.

Each of these functions should be performed by someone other than the Loan Approval Official.

Our State Internal Review guides have also been modified to assure these steps have been taken.

Finding 7 Separation of Duties Lacking for Loan and Grant Processing

Recommendation 10 – Develop policy and procedures for contacting borrowers after future disasters to classify borrower accounts and handling uninhabitable property at the least cost to the agency.

RHS Response – Agree

We agree that procedures should be developed to contact borrowers and assess damage as soon as possible after a natural disaster. CSC's Disaster Preparedness Binder and Disaster Management Action Plan provide guidance on servicing protocol during disasters, examples of customer service correspondence, loss estimates, key contacts, question and answers, and lessons learned. Use of technology, such as the geo-tracking of addresses, will make locating properties and estimating losses more useful. We believe these items adequately address the OIG concerns for future disasters.

We **strongly disagree** with OIG's finding that adequate measures were not taken in this regard following the hurricanes in 2005. Even before the hurricane hit, borrower contact was initiated by CSC to offer assistance and, ultimately, control losses to the agency. Altogether, we initiated contact with more than 58,000 affected families to discuss payment moratoriums, re-amortization of accounts, insurance claims, and other problems.

Affected portfolio numbers were provided by CSC at least as early as September 5, 2005. Loss assessments also began almost immediately, with updated information used to make constant revisions.

Officials at CSC and the Louisiana and Mississippi state offices take strong exception to those sections of the report which indicate Rural Development has failed to:

1. Determine status of affected security properties;
2. Contact borrowers in regard to plans;
3. Determine insurance coverage and expected recovery;
4. Take action to acquire 'abandoned' property through foreclosure and other means; and,
5. Issue guidance to prevent unnecessary losses.

While the report recommendation is practical and prudent for most disasters, OIG states, "The cumulative impact of hurricanes Katrina and Rita is considered by many to be the worst natural disaster in U.S. history."

The hurricanes produced devastation of an unforeseeable magnitude, precluding normal loss assessment practices such as home inspections and interviews of borrowers. Roads were impassable or no longer existed. Borrowers had fled and could not be located. When

Exhibit C – Agency Response

Exhibit C – Page 10 of 10

9

contact is made, many of those most severely affected are still unsure of plans – insurance remains unsettled, towns struggle with clean-up and future plans within flood areas, state/national/charitable funds are still forthcoming. Through December 31, 2006, all except 1,377 of more than 25,000 loans accounts receiving a hurricane moratorium were current, have an established payment plan or have servicing action in process. It should be noted properties, not 'abandoned' in the typical context but uninhabitable because of damage to the structure or the community, could not be foreclosed for an extended period due to imposed restrictions and prudent, responsible lending.

Information gathered by visiting each home securing a loan and interviewing each borrower would likely not have been more useful than the loss estimates that were made. Circumstances and plans continued to rapidly change, making yesterday's assessment quickly out-of-date. Broad damage assessments and tracking of insurance claims and other servicing actions in affected areas provided adequate information to estimate portfolio loss and guide decision makers.

In most cases, the delays cited in the report will lead to greater recovery as state and federal recovery funds are provided and areas begin to rebuild. Further, premature action suggested by the report could increase hardships for many families, work against local efforts, and violate environmental and legal requirements. Ultimately, this would be of far greater cost to the federal government.

Informational copies of this report have been distributed to:

Administrator, Rural Housing Service, Through: Director, Financial Management Division Operations and Management	4
U.S. Government Accountability Office	1
Office of the Chief Financial Officer Director, Planning and Accountability Division	1